



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR:ASSOCIATE AREA COUNSEL, CC:SBSE:8:SD

FROM: ASSOCIATE CHIEF COUNSEL (Income Tax & Accounting)

SUBJECT: Advance Payments for Goods

This Chief Counsel Advice responds to your memorandum dated May 21, 2002. In accordance with § 6110(k)(3) of the Internal Revenue Code, this Chief Counsel Advice should not be cited as precedent.

LEGEND

Taxpayer =

A =

Items =

Systems =

Year 1 =

Year 2 =

ISSUE

Should Taxpayer include in gross income a payment received for sale and installation of goods in the taxable year the payment is received (Year 1), or in the taxable year in which the goods are delivered and the installation completed (Year 2)?

CONCLUSION

We agree with your conclusion that, under the facts described in your memorandum, Taxpayer may defer the payments until Year 2, the taxable year the goods are delivered and installed.

FACTS

We understand the facts to be as follows: Taxpayer uses the accrual method of accounting, and is a dealer for A. A manufactures and sells Items and Systems. Taxpayer and the Service appear to agree that Items and Systems are goods.

Taxpayer enters into contracts with its customers under which Taxpayer designs plans for Items and Systems, and sells the Items and Systems to customers. Taxpayer orders the Items and Systems it needs for a particular contract from either A or other suppliers. When Taxpayer receives the Items and Systems it has ordered for a customer, Taxpayer installs them at the customer's site. Taxpayer uses a portion of its office space for temporary storage of Items and Systems before delivery and installation at the customer's site.

When a customer and Taxpayer enter into one of these contracts, the customer must pay a nonrefundable payment to Taxpayer. The payment generally does not cover the entire cost of the contract. Taxpayer does not hold the payment in a separate account, and the payment is available to Taxpayer without restriction. When Taxpayer delivers and installs the Items and Systems, Taxpayer bills the remaining amounts due.

Taxpayer represents that the contracts at issue usually are completed (all Items and Systems delivered and installed, and the remaining balance due) either during the taxable year in which the nonrefundable payment is received, or during the taxable year immediately following. For both financial reporting and tax purposes, Taxpayer includes in income the nonrefundable payment and balance due on a contract in the year the Items and Systems under the contract are delivered and installed.

LAW

Under § 446(b) of the Internal Revenue Code, a taxpayer's right to use a method of accounting is subject to the requirement that the method clearly reflect income. The Commissioner has broad discretion to determine whether a taxpayer's method of accounting clearly reflects income. RLC Indus. Co. v. Commissioner, 98 T.C. 457, 491 (1992), aff'd, 58 F. 3d. 413 (9th Cir. 1995).

Section 451(a) provides that the amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

Section 1.451-1(a) of the Income Tax Regulations provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income, and the amount of the income can be determined with reasonable accuracy (the “all-events test”). All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is made, whichever happens first. Rev. Rul. 80-308, 1980-2 C.B. 162.

Section 1.451-5 is an exception to the all-events test. Section 1.451-5(b)(1) states that advance payments must be included in income either in the taxable year of receipt, or, (except as provided in § 1.451-5(c)), in either of the following: a) in the taxable year in which properly accruable under the taxpayer’s method of accounting for tax purposes if such method results in including advance payments in gross receipts no later than the time such advance payments are included in gross receipts for purposes of all its reports (including consolidated financial statements) to shareholders, partners, beneficiaries, other proprietors, and for credit purposes; or, b) if the taxpayer’s method of accounting for purposes of such reports results in advance payments (or any portion of such payments) being included in gross receipts earlier than for tax purposes, in the taxable year in which includible in gross receipts pursuant to its method of accounting for purposes of such reports.

Section 1.451-5(a)(1) provides, in relevant part, that for purposes of this section, the term “advance payment” means any amount which is received in a taxable year by a taxpayer using an accrual method of accounting for purchases and sales, pursuant to, and to be applied against, an agreement for the sale or other disposition in a future taxable year of goods held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business.¹

Section 1.451-5(a)(2)(i)(b) provides that for purposes of § 1.451-5(a)(1), the term “agreement” includes an agreement that obligates a taxpayer to perform activities described in § 1.451-5(a)(1), and which also contains an obligation to perform services that are to be performed as an integral part of such activities.

Section 1.451-5(c) provides rules that apply, under certain circumstances, when a taxpayer receives substantial advance payments (as defined in § 1.451-5(c)(3)) in a

¹ Because we think that the taxpayer is within § 1.451-5(a)(1)(i), we do not discuss the applicability of § 1.451-5(a)(1)(ii).

taxable year with respect to an agreement for the sale of goods properly includible in its inventory.

ANALYSIS

For Taxpayer to defer its nonrefundable payments under § 1.451-5, the payments must be pursuant to, and applied against, an agreement for the sale or other disposition of goods held by the taxpayer primarily for sale to customers in the ordinary course of its trade or business. Section 1.451-5(a)(1)(i). Whether Items and Systems are goods “held by Taxpayer primarily for sale to customers in the ordinary course of its business” is the primary issue in dispute in this case. We agree with your conclusion that Items and Systems are held by Taxpayer within the meaning of § 1.451-5(a)(1)(i), and that Taxpayer may defer the payments at issue.

In Straight v. Commissioner, T.C. Memo 1997-569, the Tax Court held that a similarly situated taxpayer did not hold goods for sale to customers in the ordinary course of its business. In Straight, the taxpayer was a dealer for a company that sold house panel kits. The taxpayer entered into contracts with customers for the kits, received deposits pursuant to the agreements, and ordered the kits from the supplier. The supplier then delivered the kits directly to the customers. The court held that the taxpayer never owned or took title to the kits, never included them in its inventory, and thus was not entitled to use § 1.451-5 to defer inclusion of payments received pursuant to contracts for the kits.

In an unpublished order dated May 6, 1999 (Straight v. Commissioner, Docket No. 23658-94), the court reversed its holding on this issue. The case was before the court on the taxpayer’s motion for reconsideration. The taxpayer argued that (1) the advance payments were for the building, constructing, and manufacturing of the house kits under § 1.451-5(a)(1)(ii), without regard to inventory; and (2) in the alternative, that the advance payments were for the future sale of goods held by the taxpayer primarily for sale to customers under § 1.451-5(a)(1)(i) because the taxpayer was the owner and title holder of the house kits. The Commissioner did not respond to these new arguments on this issue, and the court treated this as a concession. In addition, the court found the taxpayer’s new arguments on the issue convincing (although the court did not discuss which of the new arguments it found persuasive), and held that advance payments received by the taxpayer pursuant to contracts to sell kits could be deferred under § 1.451-5.

The published opinion in Straight is not precedential on this issue, and we decline to apply it to this case. In addition, Taxpayer’s facts indicate a clearer case for deferral than the facts in Straight. In Straight, the suppliers delivered kits directly to the customers, bypassing the taxpayer. Thus, the kits were not held by the taxpayer for resale in the ordinary course of its business. In contrast to Straight, Taxpayer’s ordinary course of business is to place orders for the goods as needed, receive and temporarily store the goods, and deliver and install the goods.

Because Taxpayer physically holds the Items and Systems it orders from its suppliers prior to delivery to the customers, Taxpayer meets the requirements of § 1.451-5(a)(1)(i).

Taxpayer also appears to meet other relevant requirements of § 1.451-5. Taxpayer receives the payments pursuant to, and applied against, agreements between Taxpayer and customers. For financial reporting purposes and tax purposes, Taxpayer includes the payments in income in the year the Items and Systems are delivered, which is usually either the year of receipt or the year immediately following. In general, Taxpayer is also subject to the rules of § 1.451-5(c) regarding inventorable goods, although it is unclear from the facts whether Taxpayer's advance payments are "substantial" for purposes of § 1.451-5(c). However, because the payments are generally included in income for tax purposes either in the year of receipt or the year immediately following, we do not think that § 1.451-5(c) limits Taxpayer's deferral in this case.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS



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Please call if you have any further questions.

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